The Free Market

"If you don't create a free market, a black market will emerge"

NEWSLETTER OF THE LITHUANIAN FREE MARKET INSTITUTE - www.freema.org/Newsletter/index.phtml

NEWS

It's Time to Break up the European Tax Cartel, says LFMI

On September 13, 2004 the Lithuanian Free Market Institute (LFMI) issued a press release saying that harmonization of direct taxes in the European Union (EU) would prompt increased spending by governments of member states, while competitiveness of the EU economy and efforts to conduct immediate social and economic reforms would falter. LFMI urged EU authorities to abandon attempts at harmonising taxes whatsoever and breaking up the European tax cartel.

The press release stated the following: "Initiatives to harmonize corporate taxes, recently stepped up by some old member states, are adequate to calls for creating a cartel among EU governments, which would make life easer for national governments at the expense of European people. Undermined tax competition would markedly reduce incentives of EU governments to enhance performance of the public sector and to collect and allocate EU budget more effectively. For this reason, LFMI encourages governments of the EU member states to discard plans to harmonize direct taxes. Instead, governments should take measures to carry out social and economic reforms, which would lead to more favourable conditions to boosting people's initiatives and economic growth.

The ongoing debates over the need to harmonize direct taxes across the EU indicate politicians' stereotyped belief that tax competition is harmful. They maintain that - seeking to create a more favourable investment climate – national governments are forced to cut taxes below the optimal level which is indispensable to finance the public needs. Tax harmonization is also seen as a proper means to halt capital movement inside the EU.

LFMI says that the arguments for tax harmonisation are not farsighted. Harmonisation of direct taxes would certainly raise the tax level in the EU, and indeed would benefit the neighbouring non-member states with lower tax rates. This would surge the investment climate in the EU' neighbours and, potentially, cause reallocation of capital from the EU to non-member states.

Proposals of the old member states somewhat run counter to the principle of solidarity, although it is one of the declared virtues of the EU. Even the displayed diplomacy does not hide the old Europe's itch for shaking the competitiveness of the new member states. But, most regrettably, such proposals reveal a surprising poverty of virtues of these European democracies: instead of alleviating the tax burden for its citizens, some old EU member states attempt at forcing the remaining ones to increase the tax burden.

However, such attitude and decisions may turn around against the old European countries themselves. Taxes are not the only factor that might determine the investment climate. LFMI believes that currently the old EU countries should be more concerned about a faster wage growth in the new member states. This can be ensured only by a rapid economic development, however, tax harmonization would clearly choke it off.

It is also noticeable that some of the old EU member states that use the "card" of tax competition are simply trying to throw off the responsibility for the rampant public sector, a drastic increase in taxes, and a groundless surge of social benefits which undercut people's incentives and retard structural reforms and changes in the public sector. These factors are the primary reasons why the EU economy is at a standstill and doesn't grow at the same pace as it has been before.

LFMI thinks that hints about possible cutting of EU funds for the new member states that have low corporate taxes are not intimidating. Long-term benefits of the common market are more important than short term benefits gained from EU funds, which, *inter alia,* will also bring negative results for economies of the new member states."

LFMI draws up a health care reform proposal

In October 2003 through May 2004, LFMI implemented a project on a viable health care system in Lithuania. The primary aim of the project was to promote an effective healthcare system in Lithuania by formulating a conceptual framework and by preparing specific policy proposals for health care system reform. The project explored how costs are distributed within the health care system with a view to identifying ways of providing the most cost-effective and high-quality medical treatment. In the course of the project, LFMI cooperated with state institutions, the media, and other organizations. The project was supported by the U.S. Department of State.

To present the reform model developed during the project, LFMI launched a wide dissemination campaign. In February 2004, LFMI staged a seminar "The Prospects of Private Medical Practice in Lithuania's Health Care System." The seminar gathered around 80 participants - representatives from private and public health care institutions, the Ministry of

Health, municipalities, and insurance companies. The event was also attended by health care analysts and journalists. Heated, but constructive, discussions at the seminar testified that the issue of health care reform is of great relevance to Lithuanian society. In addition to that, LFMI's policy analysts also gave a number of interviews in the specialised media and commented widely on the proposed health care reform in national mass media.

The study on health care system reform is posted online: http://www.freema.org/Projects/Health.phtml.

LFMI analysed electoral programmes for parliamentary elections

In autumn 2004 the Lithuanian Free Market Institute (LFMI), the Institute of International Relations and Political Sciences, and the Institute of Civic Society implemented a joint project which is aimed at analysing electoral programmes submitted to the parliamentary elections of the year 2004. This project was designed to offer a structured approach to creating electoral platforms and stimulating informed public debates and prudent involvement in the election process, thus promoting sustainable, consistent and predictable policy reforms for the benefit of people's welfare. The project was financed by the Open Society Fund Lithuania and the Konrad Adenauer Foundation.

The specific objectives were to make analysis of electoral programmes of Lithuanian parties and to disseminate a questionnaire to parties and formulate conclusions based on their answers. The project findings were presented at a press conference and a conference held on October 4, 2004. The analysis was posted on Lithuania's leading web portal *Delfi*, and the questionnaire – on a special webpage of the news agency *ELTA*. Special material was prepared according to the analysis of electoral programmes and printed in Lithuania's leading business daily *Verslo Zinios*.

The analysis made by LFMI showed that the majority of programmes submitted for the 2004 parliamentary elections in Lithuania virtually do not differ from those of the previous elections. Again, short-term slogans/emphases prevail in the programmes, and social support in the first place (promises to raise wages and pensions). The absolute majority of the parties do not debate issues of long-term reforms and do not submit proposals on how to cure the health care and education system. Instead, parties focus on short-term measures that would, at best, improve the situation of certain groups of society, and, at worst, would pose serious problems to the country's fiscal system.

LFMI's study on the development of information society in Lithuania

In 2003-2004 the Lithuanian Free Market Institute participated in an international research project "Factors and Impacts in the Information Society: a Prospective Analysis in the Acceding and Candidate Countries." The project was contracted by the Institute of Prospective Technological Studies, Seville, one of seven institutes of the Joint Research Centre of the European Commission providing prospective analyses in support of the EU's policy making-process.

The goal of the project was to make an in-depth analysis of challenges and potentialities related with EU enlargement by identifying technological, economic, political and social drivers and their impact on science and technology policy, competitiveness and employment in the wider Union over a ten-year horizon.

Twelve new EU member states and candidate countries took part in this project. The Lithuanian Free Market Institute carried out and presents hereby a study on factors of information society development in Lithuania. According to an uniform methodology, the study analyses a set of factors of information society development, including macroeconomics, information society policy, industrial development, the presence of economic activities most relevant to information society (such as investments to innovations, innovation policy, R&D), information society penetration rates, education, demography, cultural and sociological factors; provides a multifactorial contextual evaluation and delineates likely future scenarios for its development.

More about the projects and the study can be accessed at: http://www.freema.org/Projects/Seville.phtml.

The EC unveiled a study on undeclared labour in the EU, containing a country-report conducted by LFMI

In the autumn of 2003 the Lithuanian Free Market Institute, among institutions from other European countries, participated in a project "An Analysis of Undeclared Work: An In-Depth Study of Specific Items," financed by Inregia AB, Sweden, and in co-operation with Regioplan, the Netherlands.

The goal of the project was to write framework country-studies into the informal economy. LFMI conducted a study on Lithuania by analysing specific items such as the description, characteristics, factors, etc. of the informal economy in Lithuania.

Country-studies have been presented in a report "Undeclared work in an enlarged Union" by Inregia AB and Regioplan BV which was commissioned by the European Commission. The report contains a description and analysis of undeclared work in the EU15 Member States, the new Member States and the candidate countries (Bulgaria and Romania). The principle objective of the research was to clarify definitions, measurement methods, estimated sizes, good practices and the gender dimension of undeclared work. The European Commission presented the study "Undeclared work in an enlarged Union" at a press briefing on July 2, 2004 in Brussels.

More about the project: http://www.freema.org/Projects/Informal.phtml.

Associate policy analysts join the team of LFMI

Seeking to utilise the potential of experienced policy analysts to full extent and searching for flexible forms of employment, the Lithuanian Free Market Institute has established a new position of an associate policy analyst. Starting from the autumn of 2004, LFMI's former Vice-president Ruta Vainiene, Senior Policy Analyst dr. Ramunas Vilpisauskas and lawyer Sigitas Groblys will take up this position.

Ms. Ruta Vainiene will co-operate with LFMI on the issues of economic, monetary and tax policies, focusing on the advocacy of LFMI's ideas in the international community. Ms. Vainiene has been with LFMI for almost 14 years since its inception in 1990. In May 2004 she decided to change her activities and moved into private business. Thanks to her expertise and efforts, LFMI has achieved significant achievements in the field of economic and monetary policy, the tax and the public finance systems in Lithuania. Ms. Vainiene holds a diploma in economics from Vilnius University.

LFMI's Senior Policy Analyst Ramunas Vilpisauskas, who accepted the proposal from the President of Lithuania back in summer, will start working as economic adviser to the President from November 1, 2004. Concurrently, he will continue co-operation with LFMI by preparing studies and generating ideas in economic issues related to the European Union and other aspects of economic policy. Working at the institute since 1997, Mr. Vilpisauskas has given a strong impetus to research on the conditions and implications of European integration and has formed LFMI's position on issues of integration into the European Union. He holds Ph.D. in social sciences, a M.A. in international relations and M.Sc. in international trade from Vilnius University as well as a M.A. in international relations and strategic studies from Lancaster University.

The ranks of LFMI's associated policy analysts have also been joined by lawyer Sigitas Groblys. He will contribute to LFMI's work mostly in the area of company law and civil law. Mr. Groblys holds a diploma in law from Vilnius University and currently is employed at the law firm *Foresta* in Vilnius.

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FEATURE

In the following article LFMI's President Ugnius Trumpa analyses the challenges that EU membership poses to free-market groups. The article was posted online at TechCentralStation (TCS), a free-market oriented, on-line think tank.

Thinking Outside the Tank

By Ugnius Trumpa, President, LFMI

New European Union countries will soon celebrate a half-year of membership in the bloc. It's a good time to consider what has been the impact of EU membership on think tanks -- and on the economic and social changes that are affecting their activities.

The past decade has brought a number of profound socio-economic changes. These changes have helped our countries to get ready for accession to the EU. There is no doubt, however, that changes have multiplied since the day we joined. If think tanks in the new member states are to have the ball at their feet, they should analyze and assess these changes thoroughly and carefully. From a strategic point of view changes in financing conditions and a growing diversity of activities are the most important ones.

Before identifying implications of EU membership for the financing of non-governmental organizations (NGOs) in general and thinks tanks in particular, one should realize that many of these changes occurred already -- several years ago. Those think tanks and NGOs that managed to recognize, evaluate and take advantage of them, avoided pitfalls or even strengthened their activities.

Let us take Lithuania, one of the new member states, as an example. To analyze financial conditions of think tanks and other NGOs in Lithuania, just like in other Central and Eastern European countries, is a difficult task. This is mainly due to a lack of data. In the past ten years scant research has been done on the financing of NGOs in general and think tanks in particular. As a result, there are few sources of data about NGO financing, while the quantity and quality of available information are fairly modest. Some foundations, think tanks and NGOs in Lithuania have conducted research to explore the motives and legal conditions of, and the trends in, giving. Yet, analysis of the scope of giving has never been attempted, so the only source of this type of information in Lithuania is the Department of Statistics.

Accountants for non-governmental organizations in Lithuania have to spend an enormous amount of time calculating and manually filling in intricate reporting forms required by the Department of Statistics. In spite of the complexity of these forms and all the work that goes into completing them, a closer look at the data released by the Department of Statistics shows that to extract any valuable information about NGO financing from the statistical yearbooks is not easy at all. If you take, say, data by area of activity (for example, funding provided for health care initiatives by Lithuanian and foreign donors), it is not clear whether they include governmental or semi-governmental organizations (public institutions) co-founded by one or more state institutions or whether they refer only to non-governmental organizations.

Similar ambiguities will come up if you try to see how donations split by institutions: the category "Scientific, educational, cultural, publishing and sports organizations" is so broad that any kind of institution may fall under it. The category "business enterprises," which is listed in this cross-section, is even more confusing, since the existing rules of granting charity and support in Lithuania prohibit enterprises from receiving donations.

Given such distortions of information, any analysis of the financing of NGOs and think tanks is general at best. Still, let us have a look at least at such generalizations. What first catches the eye is that the amount of overseas donations has shrunk in the past six years, from approximately 235 million litas in 1996 to 117 million litas in 2002. Admittedly, the total amount of donations rose from 271 million litas to 317 million litas during the said period, but this growth was caused by increased giving from local donors (from almost 36 million litas in 1996 to 117 million litas in 2002).

These changes were discernible earlier, since the long-awaited economic growth, international recognition and integration into NATO and the European Union had adverse implications for thinks tanks that counted mostly on foreign donations. As the living standard in the country rose and the political situation stabilized, international foundations began to lose interest in Lithuania in favour of African, Asian, Middle East, CIS and other less economically advanced and politically stable countries. Most international organizations and foundations began to withdraw from Central and Eastern European countries or narrowed their activities or reduced funding in this region already several years ago. Today our former donors who think that we have achieved a comfortable living can be reminded that the living standard in our country is eight times lower than that in the EU average. Still, they are right to say that many more countries are struggling with poverty than we are.

An important factor underlying the reduction of international support has been the economic decline of the world's leading economies and their internal social problems which have been absorbing resources in the first place. These processes became quite obvious when large international donor foundations withdrew from Lithuania and the remaining organizations markedly cut down their funding. Funds that were designated for the country's integration in international organizations shrank as well.

In designing next year's activities, allowance should be made for a strong probability that, after accession into the European Union, donations from the US, which account for 32 percent of total international funding today, will go down. At present it is not clear how things will stand with funding from other large international donor-countries, such as Denmark (almost 19 percent of total international funding), Germany (16.1 percent), Finland (7.8 percent) or Sweden (6.5 percent). Upon Lithuania's joining the EU, these countries are not only colleagues but also competitors.

In the face of such developments leaders of think tanks are very likely to ask themselves: And what about tomorrow? Shall we compete fiercely for shrinking international donations? Or shall we persuade ourselves and others that there is no way we could get along without international support? Such tactics are still feasible today, but I sincerely doubt it would justify itself in the long term.

How should think tanks change and what should they do under the current developments if they want to proceed with their missions and objectives? Identifying and eliminating shortcomings is their first priority. For many years think tanks learned how to write grant applications and how to raise funds. They struggled hard for donations both domestically and internationally. To obtain them, think tanks inevitably modelled their activities on the programs and fashions that were set by the foundations they approached. In many cases this led think tanks to forego their originality and identity, as economic interests invariably made them alter their strategies and tactics, their management and expertise.

Competing interests outweighed cooperation possibilities. They outweighed opportunities to learn from partners and to develop international projects and to enhance their expertise in other ways. Some foundations discerned these adverse trends before it was too late and started to finance networking and international cooperation. Despite that, much time was lost and as a result on May 1 many Lithuanian NGOs entered the common EU market equipped only with local experience.

As NGOs kept themselves narrowly focused on donations from foundations, they lost time and opportunity to find local and foreign donors in the private business community or among individual philanthropists and to exhibit themselves as representatives of community, national or international interests. Many projects undertaken by NGOs had little in common with community interests or any wider interests so that NGOs and their donor foundations ended up being the final and biggest beneficiaries of these projects. Consequently local donors from the private business community were lost. It is likely that a recent rise of communities and their activities, coupled with a provision of the 2003 law on personal income tax allowing Lithuanian taxpayers to allocate 2 percent of their income tax to charity, will lead Lithuanian NGOs to look for potential donors among business enterprises and private individuals.

Equally erroneous was a strategy to stake one's existence on state or municipal funding. Such NGOs wasted time on "extorting" money from the government through political parties or connected officials instead of focusing on fundraising from potential private donors. In a situation where societal problems are widely expected to be tackled not by civic organizations but by the government and private individuals and legal entities have to make generous contributions to maintain the government, little incentive is left to support not too strong and attractive civic organizations and to bank on their worthy accomplishments.

Little wonder that the issues NGOs and think tanks are addressing are widely believed to be the domain of the state or charitable organizations or foundations. Such perceptions were reported in most of the surveys on the visibility and attractiveness of NGOs and think tanks among potential investors. For example, according to a public opinion poll "Philanthropy in Lithuania 2003" commissioned by the Open Society Fund-Lithuania, the majority of potential donors think that social care, science, education, health care, environment protection and culture should be supported, not by private individuals or companies, but by the government. Naturally, as long as this opinion prevails and government agencies continue to usurp the role of the benefactors instead of yielding it to private initiative and responsibility, NGOs that are active in these areas can hardly count on any private giving. Following this line of reasoning, it is not surprising at all that the bulk of private donations are going to organizations where "the hand of the state" is felt the least, for example, religious organizations.

A positive trend that has been evolving since ten new countries joined the EU is first of all a new market of ideas in the expanded Europe. Internal problems of the member states, neighbourhood relationships and issuing evolving at the EU level will require many innovative decisions. Think tanks will have an opportunity to exploit their exceptional advantages, advantages that private enterprises and state agencies cannot boast. Public policy areas will be expanded to include new issues and new problems both at the national level and in the EU domain soon after the EU expansion. Given that the new member states will gradually adopt new practices of public administration and policy making that are already established or have been recommended in the EU, our politicians and civil servants will be very likely to change their attitudes towards think tanks and to rethink the advantages that think tanks possess.

The involvement of think tanks in the policy making process is a normal and long-standing practice of governing bodies at both member state and EU level. The expanded Europe means not only a common market of goods and services but also a common market of public policy issues in which various types of think tanks can find a niche. Some think tanks will be able to focus their efforts, independently or cooperatively, on the nations that are awaiting another round of EU expansion or on other neighbouring countries that are set to accelerate their economic and social growth.

Think tanks in the new member states will be able to use on a wider scale the experience of their counterparts in the old member states and to establish new coalitions that would address, and formulate proposals for, national and EU public policy issues. The market for policy advocacy and education is no smaller than the market of internal issues of the EU and its member states.

Finally, it should be stressed that the European Union has accepted nations which have much more dynamic experience of free-market reforms than the old member states. The European Commission, the Council of Ministers and the European Parliament can use this background not only a source of valuable experience but also as a tool of policy making to put the reforms in the European Union and its member states on the free-market path.

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FEATURE

The following article was posted online at TechCentralStation (TCS), printed a free-market oriented, on-line think tank. It was sparked off by the French Finance Minister's recent initiative towards harmonization of corporate taxes across the EU.

Tax Terrorism

By Ruta Vainiene, Associate Policy Analyst, LFMI

The *Longman Dictionary of Contemporary English* defines the word "terrorize" as "to deliberately frighten people by threatening to harm them, especially so they will do what you want". It's not just political terrorism we are facing today. A French initiative to harmonize direct taxes can be viewed as a clear manifestation of economic terrorism.

Recently the French finance minister has "deliberately frightened" EU countries with low taxes by "threatening to harm" them. How? By restricting their use of EU structural funds if they don't raise corporate tax rates.

EU tax laws cannot be changed unless all member states agree. This unanimity requirement has been the only safeguard to slow the movement of tax harmonization. But, as we all know, attempts to abolish the right of veto have been quite active lately and will certainly be put forward again. When? I am afraid; as soon as it appears that the terrorizing deeds don't bring the waited results. And if the right of veto is abolished, Europe will witness genuine economic terrorism where violence of the strong and the big against the small and the weak is the moving engine.

The situation is disturbing, since everybody knows that terrorism provokes a "lose-lose" situation. It benefits neither the attacking nor the attacked side. The only gain that companies would derive from it is equal rules that are easier to follow.

But to raise taxes for the sake of simplicity is far from a brilliant idea. Companies would certainly agree to spend time learning different rules if this enabled them to pay less in taxes. Actually, they are used to doing so and they will continue searching for low-tax places to do business. If they don't find such places in Europe, they will seek for them elsewhere around the globe.

Let's have a look at what lies behind the intentions to increase tax rates in the new member states. Why do high tax countries have a relentless itch to put an end to the so-called "harmful" tax competition, or to be more precise - to end tax competition as such? The most conceivable explanation is that countries with high taxes are simply frightened at any form of competition as they are almost sure they will lose the battle.

Taxes directly affect production costs. High taxes increase these costs. As a result, it becomes more expensive to produce, and more difficult to sell, goods and services. Add lower labour costs and cheaper energy resources in the new member states and you will be facing a rather strong competitor.

Fears of losing investments along with all the resulting effects are the main reason why high tax countries are so conspicuously afraid of countries new to Europe which are economically still weak today - weak, but with huge potential for growth.

Rapid economic growth is vital for the new member states. For example, the average personal income in Lithuania is just 40 percent of the EU average. People are not well off, and the only way to reach the EU level is to grow faster. Low taxes lay the foundations for economic growth.

If taxes are raised, growth will undoubtedly be arrested, and the new member states will remain the poor outskirts of the rich Europe for much longer than under the current tax rates. The question is whether the "old European" countries are interested in having poor sisters and brothers. Or are they simply short-sighted in their goals?

To have a feeble companion is much worse than to have a wealthy one, and I bet that successful businessmen would certify that. If Europe is eager to be a "success story," competition should be allowed to work inside the Union. Europe must be concerned about having each member competitive and strong, even more so if this may be achieved without sacrificing the wealth of others.

Competition is not about living at the expense of one's neighbour. It is about searching for own ways to survive. It is not about cutting and dividing a fixed pie. It is about creating a bigger pie.

The wealth of the "old Europe" - if maintained and supported by the means of economic terrorism - will not be sustainable at all. Economic terrorism is about refusing wealth.

If harmonization takes place, in a year or two all countries will face even bigger difficulties in creating a competitive Europe. Why? Because the core of the problem would not be solved, not even touched. The problem would be only postponed and aggravated. Eventually, a tax cartel will be created.

A state cartel is much more harmful than the allegedly harmful tax competition itself. It limits an individual's right to choose and damages private finances. I doubt if there's someone courageous enough to say that private finances are not important and that they should fall victim to state finances.

The remedy for Europe is not a tax harmonization or economic terrorism, but the implementation of serious economic reforms that would unleash economic initiative. It is a test of Europe's readiness to pursue urgent change, and at the same time a chance to do so. It is a unique opportunity to follow the well-tried recipe for growth which is being proposed by the low tax countries, and this opportunity should not be wasted.

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If you don't create a free market, a black market will emerge

The founders of LFMI are – Prof. Kęstutis Glaveckas, Nijolė Žambaitė, Dainius Pupkevičius, Petras Auštrevičius, Elena Leontjeva and Darius Mockus.

LFMI pursues its mission by conducting research on key economic policy issues, developing conceptual reform packages, submitting policy recommendations at the legislative and executive levels, drafting and evaluating legislation, and launching public campaigns. LFMI‘s activities also include sociological surveys, publications, conferences, workshops, and lectures.

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